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ORIGINAL

OPEN MEETING ITEM

19

THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

MAR 14 2001

WILLIAM A. MUNDELL
CHAIRMAN
JAMES M. IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER



IN THE MATTER OF THE APPLICATION OF
U S WEST COMMUNICATIONS, INC. A
COLORADO CORPORATION, FOR A HEARING
TO DETERMINE THE EARNINGS OF THE
COMPANY, THE FAIR VALUE OF THE
COMPANY FOR RATEMAKING PURPOSES,
TO FIX A JUST AND REASONABLE RATE OF
RETURN THEREON AND TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP SUCH
RETURN.

DOCKET NO. T-01051B-99-0105

NOTICE OF FILING

Pursuant to the request of the Commissioners at the Open Meeting of March 7, 2001,
Staff and Qwest jointly submit the attached substitute Proposed Order and Settlement Agreement.
The Proposed Order reflects the amendment adopted by the Commission on March 7, 2001, and
Commissioner Spitzer's Revised Proposed Amendment No. 3. The substitute Proposed Order is
submitted in redline version, showing changes made from the Administrative Law Judge's original
Recommended Opinion and Order.

Qwest and Staff have modified the attached version of the Settlement Agreement and
Price Cap Plan to be consistent with the attached Proposed Order by incorporating: (1) the changes
to the Settlement Agreement contained in the Recommended Opinion and Order submitted by the
Administrative Law Judge; (2) changes consistent with the amendment adopted on March 7, 2001;
(3) Commissioner Spitzer's Revised Proposed Amendment No. 3; and (4) to correct a rounding error
relating to the effect of the reduction in Residential Basic Service Nonrecurring Charges at page 3
of the Settlement Agreement. The Settlement Agreement is submitted in redline version, but the
Price Cap Plan is not. Changes are identified in the text of the submitted version of the Settlement
Agreement, but not the Price Cap Plan.

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1 By submitting the substitute Proposed Order and Settlement Agreement, Staff and
2 Qwest have not waived their positions that the original Settlement Agreement as submitted should
3 be approved by the Commission. Staff and Qwest have not entered into any further Settlement
4 Agreement and Price Cap Plan, nor agreed to the terms and conditions set forth in the substitute
5 Proposed Order and Settlement Agreement and Price Cap Plan to the extent they vary from the
6 original. Staff and Qwest continue to support the points made in their exceptions.

7 The substitute Proposed Order, Settlement Agreement and Price Cap Plan provided
8 with this Notice of Filing are submitted for illustrative purposes. By filing the substitute Proposed
9 Order and Settlement and Price Cap Plan, Qwest has not waived the right to accept or reject the
10 Settlement Agreement, as modified by any Proposed Order ultimately adopted by the Commission.

11 RESPECTFULLY SUBMITTED this 14th day of March, 2001.

12
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24 The ORIGINAL and fifteen Copies of the
25 foregoing were filed this 14th day of March,
26 2001 with:

27 Docket Control
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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 WILLIAM A. MUNDELL
CHAIRMAN

3 JIM IRVIN
COMMISSIONER

4 MARC SPITZER
COMMISSIONER

6 IN THE MATTER OF THE APPLICATION OF U S
7 WEST COMMUNICATIONS, INC. A COLORADO
8 CORPORATION, FOR A HEARING TO
9 DETERMINE THE EARNINGS OF THE
10 COMPANY, THE FAIR VALUE OF THE
11 COMPANY FOR RATEMAKING PURPOSES, TO
12 FIX A JUST AND REASONABLE RATE OF
13 RETURN THEREON AND TO APPROVE RATE
14 SCHEDULES DESIGNED TO DEVELOP SUCH
15 RETURN.

DOCKET NO. T-01051B-99-0105

12 IN THE MATTER OF U S WEST
13 COMMUNICATIONS, INC. TARIFF FILING FOR
14 APPROVAL OF A \$.25 SURCHARGE FOR A
15 CALL TO A U S WEST 800 SERVICE LINE
16 FROM A PAY TELEPHONE.

DOCKET NO. T-01051B-00-369

DECISION NO. _____

OPINION AND ORDER

15 DATES OF HEARINGS:

September 16, 1999; April 4, April 12, May 3, June 16,
July 25, July 28, October 16, November 2, November
22, 2000 (pre-hearing conferences), November 29,
November 30, December 1, and December 4, 2000.

17 PUBLIC COMMENTS:

June 21, 2000 – Flagstaff, Arizona; July 6, 2000 –
Prescott, Arizona; July 11, 2000 – Payson, Arizona; July
26, 2000 – Globe, Arizona; August 3, 2000 – Phoenix,
Arizona; August 14, 2000 – Tucson, Arizona; August
30, 2000 – Yuma, Arizona; September 5, 2000 – Sierra
Vista, Arizona; and September 6, 2000 – Bisbee,
Arizona; *February 21, 2001 - Phoenix, Arizona;*
February 22, 2001 - Tucson, Arizona and March 1,
2001 - Prescott, Arizona.

22 PLACE OF HEARING:

Phoenix, Arizona

23 ADMINISTRATIVE LAW JUDGE:

Jane Rodda

24 IN ATTENDANCE:

Carl J. Kunasek, Chairman
Jim Irvin, Commissioner
William A. Mundell, Commissioner

26 APPEARANCES:

Mr. Timothy Berg and Ms. Theresa Dwyer,
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1 Ms. Joan S. Burke, OSBORN MALEDON, P.A., Mr.
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3 WRIGHT TREMAINE, LLP, and Mr. Richard S.
Wolters, on behalf of AT&T Communications of the
Mountain States, Inc.;

4 Mr. Raymond S. Heyman, ROSHKA, HEYMAN &
5 DEWULF, PC, on behalf of the Arizona Telephone
Retiree Association and Arizona Payphone Association;

6 Mr. Thomas H. Campbell and Mr. Gregory Y. Harris,
7 LEWIS AND ROCA, LLP, on behalf of Rhythm Links
Communications;

8 Mr. Michael W. Pattern, BROWN & BAIN, P.A., on
9 behalf of Cox Arizona Telecom and e-spire™
Communications;

10 Mr. Thomas F. Dixon, Jr., on behalf of MCI WorldCom;

11 Mr. Scott S. Wakefield, Chief Counsel, and Ms. Jessica
12 L. Carpenter, Staff Attorney, on behalf of the
Residential Utility Consumer Office;

13 Mr. Richard Lee, SNAVELY, KING & MAJOROS, and
14 Mr. Peter Q. Nyce, Jr., General Attorney, on behalf of
the Department of Defense and Federal Executive
15 Agencies;

16 Mr. Bradley S. Carroll on behalf of Cox Arizona
Telecom, Inc.;

17 Mr. James McGillivray on behalf of intervenors J.E. and
18 B.V. McGillivray;

19 Mr. Darren S. Weingard on behalf of Sprint
Communications Co., L.P.;

20 Mr. Joseph Gosiger and Ms. Diane Bacon on behalf of
21 the Communications Workers of America;

22 Mr. Michael M. Grant, GALLAGHER & KENNEDY;
on behalf of Citizens Utilities Company; and

23 Mr. Christopher Kempley, Assistant Chief Counsel, and
24 Ms. Maureen Scott, Staff Attorney, Legal Division, on
behalf of the Utilities Division of the Arizona
25 Corporation Commission.
26
27
28

1 **BY THE COMMISSION:**

2 On January 8, 1999, Qwest Corporation ("Qwest") formerly known as US West
3 Communication Co., Inc. filed an application for an increase in rates with the Arizona Corporation
4 Commission ("Commission").

5 Procedural Background

6 Our Procedural Order dated March 4, 1999, established a schedule for filing testimony and set
7 a hearing for November 4, 1999. In October 1999, Qwest and Commission Utility Division Staff
8 ("Staff") filed a joint motion to continue the procedural dates pending resolution of Qwest's pending
9 depreciation case (Docket No. T-1051-97-0689). A Procedural Order filed January 7, 2000,
10 continued the hearing pending resolution of the depreciation docket and suspended the time clock
11 rules.

12 In January 2000, Staff filed a Motion for Qwest to update the test year. A Procedural
13 Conference was held on April 4, 2000 and Qwest was directed to re-file its schedules using a
14 calendar year 1999 test year. Qwest filed updated testimony on its revenue requirement and rate of
15 return on May 3, 2000, and updated testimony on rate design, cost studies and RCND on May 19,
16 2000. Our Procedural Order filed May 5, 2000, set dates for filing testimony and scheduled a hearing
17 for September 25, 2000. Our July 27, 2000 Procedural Order set revised dates for filing testimony of
18 all parties.

19 Public Comment sessions were held in Flagstaff, Prescott, Payson, Globe, Phoenix, Tucson,
20 Bisbee, Sierra Vista and Yuma throughout June, July and September, 2000. On August 9, 2000 Staff
21 and intervenors filed direct testimony. On August 21, 2000, Qwest filed rebuttal testimony. On
22 September 8, 2000 Staff and intervenors filed surrebuttal testimony. On September 19, 2000, Qwest
23 filed rejoinder testimony.

24 On September 19, 2000, Staff and Qwest filed a motion to continue the hearing pending
25 discussions on possible settlement. By Procedural Orders dated October 4, and October 17, 2000, the
26 hearing was continued until November 29, 2000. On October 20, 2000, Qwest and Staff filed a
27 Settlement Agreement addressing all of the issues raised in the rate case.

28 On October 27, 2000, Qwest, Staff and Communication Workers of America ("CWA") filed

1 direct testimony on the Settlement Agreement. On November 8, 2000 and November 13, 2000, the
 2 Residential Utility Consumer Office ("RUCO"), AT&T Communications of the Mountain States, Inc.
 3 ("AT&T"), Cox Arizona Telecom L.L.C. ("Cox") and the Department of Defense ("DOD") filed
 4 direct testimony on the Settlement Agreement. On November 15, 2000, RUCO filed additional direct
 5 testimony on the Settlement Agreement. On November 20, 2000, Qwest and Staff filed rebuttal
 6 testimony on the Settlement Agreement. On November 28, 2000, the ~~American~~ *Arizona* Payphone
 7 Association ("APA") filed testimony in support of the Settlement Agreement.

8 On November 29, 2000, through December 4, 2000, the Commission conducted a hearing on
 9 the Settlement Agreement. Public comment was heard prior to the commencement of the evidentiary
 10 proceeding. Following the hearing, on December 18, 2000, the parties filed post-hearing briefs. On
 11 December 18, 2000, Staff filed a revised Settlement Agreement that incorporated language
 12 clarifications that had been discussed during the hearing. On December 26, 2000, Staff and Qwest
 13 filed a Response to Suggested Revisions of RUCO, Cox and AT&T, attaching a Second Revised
 14 Settlement Agreement and Price Cap Plan. On January 8, 2001, AT&T filed a Reply to Price Cap
 15 Plan Revisions of Staff and Qwest, stating that the proposed revisions do not address AT&T's major
 16 concerns.

17 Settlement Agreement Terms

18 In the Settlement Agreement and its attendant Price Cap Plan,¹ Staff and Qwest proclaim that
 19 in reaching the settlement of the rate case, it is their intent to create incentives for Qwest to improve
 20 efficiency, to provide new and innovative service offerings and to reduce the opportunity for cross-
 21 subsidization of competitive services by non-competitive services. The Price Cap Plan has a term of
 22 three years, and is intended to provide rate stability to consumers by capping rates for essential
 23 services and could lead to rate decreases as a result of productivity gains.

24 In the Settlement Agreement, Qwest and Staff agree that the "fair value" of Qwest's Arizona
 25 rate base for the test year ending December 31, 1999 is \$1,446.0 million and that a reasonable rate of
 26 return on the fair value rate base is 9.61 percent. The fair value rate base and rate of return are the

27 _____
 28 ¹ A copy of the Second Revised Settlement Agreement and Price Cap Plan are attached hereto as Exhibit A, and
 incorporated herein by reference.

1 same figures that Staff proposed in its testimony filed prior to negotiating the Settlement Agreement.
 2 Based on the foregoing rate base and return figures, Staff and Qwest negotiated a revenue
 3 requirement deficiency of ~~\$42.9~~ \$23.3 million.

4 The Price Cap Plan divides Qwest's services into "baskets". Basket 1 consists of Basic/
 5 Essential Non-competitive Services, such as basic residential service, *and* basic business service,
 6 ~~directory assistance, private line services,~~ among others. Basket 2 consists of wholesale services, and
 7 Basket 3 consists of flexibly-priced competitive services. The parties to the Settlement Agreement
 8 agreed that the revenue requirement deficiency would be recovered through 1) ~~a combination of~~
 9 ~~increases in rates for services in Basket 3~~ and decreases in rates for services in Basket 1 amounting
 10 to a ~~net increase of \$17.6~~ total reduction of \$14.4 million and 2) the opportunity to recover ~~\$25.3~~
 11 ~~\$42.7~~ million from the flexibly-priced competitive services in Basket 3. Qwest and Staff also agreed
 12 that rates for Intrastate Switched Access Service, part of Basket 2, would be reduced by \$5 million in
 13 each year of the Plan. Revenues from Basket 3 services are allowed to increase by \$5 million in each
 14 year of the Plan to correspond to the reduction in access revenues.

15 Under the terms of the Settlement Agreement, Staff and Qwest have agreed to a Price Cap
 16 Plan. The Price Cap Plan provides that Basket 1 Services will be capped and subject to an "Inflation
 17 minus Productivity" indexing mechanism. Thus, when productivity exceeds inflation, rates will
 18 decrease. The Productivity Factor for the initial term of the Plan is 4.2 percent, which includes a 0.5
 19 percent consumer dividend. Certain Basket 1 services (including Basic Services such as flat rate
 20 residential, flat rate business, telephone assistance programs, caller ID block, toll blocking, among
 21 others) are subject to a "hard cap". These "Basic" services are capped at their initial levels
 22 throughout the term of the Price Cap Plan and may be reduced according to the Price Cap Index, but
 23 cannot increase. Individual rate elements for the other Basket 1 services may not increase by more
 24 than 25 percent within a year.

25 Basket 2 services are primarily wholesale in nature and generally governed by their own
 26 specific pricing rules and will continue to be governed by such rules. Thus, except for the reduction
 27 in Switched Access rates described above, Basket 2 services (including Discounted Wholesale
 28 Offerings, Unbundled Network Element Offerings, and wholesale services such as PAL lines) will

1 remain at their current rates until the specific pricing rules are changed or the Commission determines
2 that other prices are appropriate.

3 Basket 3 contains services already accorded pricing flexibility or determined by the
4 Commission to be competitive, and new services and service packages. Basket 3 services are subject
5 to a price cap that allows a ~~40~~ 13.4 percent increase in gross revenue over the term of the Plan, not to
6 exceed ~~\$25.3~~ \$42.7 million on a test year basis (subject to an increase of \$5 million, in the second
7 and third years to compensate for the lower switched access revenues).

8 The Price Cap Plan contemplates that new services and packages of services will be placed in
9 Basket 3, and provides that Basket 1 services may be combined with other services and be placed in
10 Basket 3, but must also remain available as a Basket 1 service. The Price Cap Plan subjects new
11 service offerings to Commission review in the same manner as tariff filings have been considered in
12 the past. The Plan permits Qwest to offer new services and packages in Basket 3 to selected
13 customer groups based on purchasing patterns or geographic location, but prohibits Qwest from red-
14 lining based on wealth or race or discriminating against any class of customers in violation of A.R.S.
15 Section 40-334. Basket 1 services may be moved to Basket 3 upon Qwest meeting the criteria of
16 R14-2-1108 (which requires a finding that the service is competitive).

17 The Settlement Agreement requires Qwest to submit an application for continuation or
18 modification of the Price Cap Plan nine months prior to its expiration, to be reviewed by Staff and
19 RUCO. Continuation or modification of the Plan is subject to Commission approval and the Plan
20 remains in effect pending a Commission decision renewing, modifying or terminating it.

21 The Settlement Agreement also amends the terms of Qwest's Service Quality Plan tariff to
22 provide that in the event Qwest is subject to penalties under two or more categories in the Service
23 Quality Plan tariff, it will be required to pay additional credits of \$2.00 per residential or business
24 access line, above those which would already be required under the tariff. The Settlement Agreement
25 provides that no additional service quality penalties or credits will be imposed during the initial term
26 of the Price Cap Plan, but clarifies that it does not preclude the imposition of penalties or standards
27 for wholesale services.

28 ...

1 The Settlement Agreement provides that in the event there is a change of controlling state or
2 federal law, or the Price Cap Plan is found to be unlawful, Staff and Qwest shall discuss whether the
3 Plan can be modified, and that Qwest shall have no obligation to refund revenues collected during the
4 period of the Price Cap Plan.

5 **Arguments For and Against the Settlement Agreement**

6 Staff and Qwest argued that the Settlement Agreement and Price Cap Plan present an
7 alternative form of regulation that benefits consumers by providing the stability of a rate cap on
8 essential basic services, reducing switched access rates and encouraging competition by allowing
9 Qwest pricing flexibility in areas where there is competition. Staff noted that if the Commission
10 approves the Settlement Agreement it will become one of 41 states to use Price Cap regulation. Staff
11 believed that the benefits of Price Cap regulation are to encourage a company to become more
12 efficient and innovative but still protect still captive consumers and competitors during the transition
13 to fully competitive markets. Consumers will benefit from an "inflation less productivity" cap which
14 will reduce Basket 1 non-competitive services in the aggregate when the productivity offset exceeds
15 inflation. In addition, there are certain basic/essential services that are subject to a hard cap and
16 cannot increase over the term of the Plan. Other basic services and individual rate elements may
17 increase no more than 25 percent in each year. Some customers will see reductions in their monthly
18 bill due to the elimination of zone charges in exchanges with expanded base rate areas and the Plan
19 reduces rates for installation of basic residential service and eliminates the initial charge to connect
20 service in rural areas.

21 The DOD, the CWA and the APA support the Settlement Agreement.

22 RUCO, the Arizona Consumers Council, AT&T and Cox opposed the adoption of the
23 Settlement Agreement and Price Cap Plan because they believed the Plan's structure does not meet
24 the goal of benefiting consumers and promoting competition. They argued that one of the Plan's
25 purposes to allow Qwest to "compete more effectively" is wholly inconsistent with the
26 Telecommunications Act of 1996 and the Commission's policy of encouraging competition. These
27 parties believed that the tools of competition afforded to Qwest under the Plan allow Qwest to
28 operate in an anti-competitive way. They also assert that the Settlement Agreement and Price Cap

1 Plan contain too much ambiguity and uncertainty to be in the public interest. Furthermore, they
 2 argue, introducing a new form of regulation in the context of a settlement agreement between two
 3 parties compromises the issues and does not lead to the best long-term policy. The major issues of
 4 debate are discussed below.

5 Proposed Revenue Requirement

6 RUCO and AT&T argued that the proposed revenue requirement is too high. Prior to the
 7 Settlement Agreement, Qwest had requested a revenue increase of \$201 million; Staff recommended
 8 an increase of \$7.2 million, RUCO recommended a decrease of \$34 million, the DOD recommended
 9 a decrease of \$52 million and AT&T recommended a decrease of either \$45 million or \$308 million
 10 (depending on the method of imputing directory revenue).

11 RUCO argued that when adopting a price cap plan, the starting level for rates is critically
 12 important to its optimum success, because if rates are set too high Qwest's over-earnings would
 13 continue for the term of the plan. RUCO noted that in several other states local exchange carriers
 14 have been required to implement rate reductions or additional infrastructure investment as a trade for
 15 pricing flexibility under a price cap plan.

16 AT&T and RUCO complained that Staff and Qwest considered only Staff's recommended
 17 adjustments in deriving the negotiated revenue deficiency, ignoring other parties' adjustments.
 18 RUCO noted that it proposed several adjustments not proposed by Staff and some that were similar
 19 to, but exceeded Staff's adjustments.

20 Staff believes the overall revenue requirement increase contained in the Settlement
 21 Agreement provides just and reasonable rates. Staff noted that several of the disputed revenue issues
 22 have no guiding precedent in Arizona and Staff believed that if Qwest prevailed on only a few, the
 23 resulting rate increase would be much higher. Both Staff and Qwest explained they did not engage in
 24 issue specific negotiations, but rather negotiated the revenue requirement on an overall basis. Staff
 25 noted that if a "split the baby" approach was taken to deriving the revenue requirement, it would have
 26 taken the midpoint between Qwest's \$201 million request and the DOD's lowest recommendation

27 ...

28 ...

(minus \$52 million)² to arrive at a revenue requirement of \$74.5 million. Even a "split the baby" approach between Staff and Qwest proposals alone would have resulted in a revenue requirement deficiency of \$97 million.

DOD found the Settlement Agreement to be a reasonable compromise given the many contentious issues raised by the parties and the inherent uncertainty of revenue requirement projections.

After consideration of the entire record, the negotiated revenue requirement is reasonable. It is based in part on Staff's proposed fair value rate base and rate of return. Staff's recommended fair value rate base was the lowest of the three parties who submitted testimony on the issue.³ In accepting the agreed upon revenue increase, we of course, are not determining how the Commission would decide any particular issue. In the context of the Settlement Agreement before us, which includes the allocation of the increase between competitive and non-competitive services, hard caps of certain basic essential services, lower prices for other basic services, lower switched access rates and a productivity index capped at zero, the evidence supports a finding that the negotiated increase of ~~\$42.9~~ \$23.3 million is within the range of reasonable results.

Of the ~~\$42.9~~ \$23.3 million increase, ~~\$17.6 million will derive from an increase in some basic non-competitive competitive services, primarily from directory assistance rates and rates for private line services, while the remaining \$25.3 million increase will derive from competitive services~~ the only rates to be increased are Basket 3 services that can be increased up to \$42.7 million as competitive market conditions may permit, offset by \$19.4 million in immediate rate reductions in Basic/Essential Non-competitive services. Currently, all the services in Basket 3 are already flexibly priced. Depending on market conditions, Qwest may or may not be able to attain the authorized increase in revenue allocated to these services.

Productivity Factor

AT&T and RUCO argued that the proposed productivity factor is too low. The purpose of the productivity offset in a price cap plan is to pass a carrier's reasonably anticipated increases in

² Setting aside AT&T's recalculated directory imputation, which Staff characterized as aberrant.

³ Staff's recommended return on equity was 11.75 percent; RUCO's was 11.5 percent; and Qwest's was 14 percent.

1 productivity on to consumers through rates. They believed that the proposed productivity factor of
2 4.2 percent fails to adequately represent the productivity increases that Qwest is likely to experience
3 over the life of the Price Cap Plan. Recently, the Federal Communications Commission ("FCC")
4 adopted a 6.5 percent productivity offset. Additionally, Qwest recently agreed to a 6.2 percent
5 productivity factor in Utah. RUCO believed that those states that set productivity factors in the 3-4
6 percent range several years ago discovered that carriers are over-earning, which indicates the 3-4
7 percent range is too low.

8 Because the productivity factor used in the Settlement Agreement was based on an analysis of
9 Qwest's historic productivity from ~~1985~~ **1995** to 1998, RUCO and AT&T argued that it fails to
10 recognize the productivity increases expected from the Qwest/ US West merger or the sale of rural
11 exchanges to Citizens Communications Co.

12 Staff argued that the 6.5 percent X-factor adopted by the FCC as part of the CALLS
13 settlement plan is used as a transition mechanism to reduce access charges to targeted levels, rather
14 than simply as a productivity offset. Staff believed that Qwest accepted a major concession with
15 respect to the productivity factor when it agreed that the productivity calculation is capped at zero
16 and has no lower bound. Thus, in this Agreement Qwest has accepted the risk of inflation for the
17 term of the Plan. This provision is not contained in the FCC CALLS settlement plan or the plans of
18 other state commissions, as those plans allow increases in prices to the extent inflation exceeds
19 productivity. Staff also noted that the 6.2 percent productivity rate agreed to in Utah was the result of
20 a settlement of the Qwest/ US West merger and is only in effect for one year.

21 DOD believes the 4.2 percent productivity factor was realistic and that the three year term of
22 the Price Cap Plan represents a long enough period to provide Qwest with a real incentive, but a short
23 enough period to prevent Qwest from reaping a windfall if the productivity factor turns out to be too
24 low.

25 The Productivity Factor contained in the Settlement Agreement is reasonable in light of all the
26 evidence. The Price Cap Plan term is for only three years, and if the Commission finds Qwest has, or
27 is expected to, enjoy greater productivity gains than it has in the past, this factor, as well as other
28 terms of the Agreement, can be adjusted. At that time the expected benefits from the merger will be

1 measurable. Each state in determining an appropriate productivity factor has different starting points
2 and issues that concern them. We note that in the past year in approving the Qwest/U S West merger
3 and the sale of certain exchanges to Citizens Communications Co., the Commission has required
4 Qwest to make substantial investments in the state.

5 Basket Structure

6 RUCO argued that the Price Cap Plan is flawed because it does not separate residential and
7 business services into separate baskets. RUCO claimed that by placing business and residential
8 services together in one basket permits Qwest to raise the price of some residential services (those not
9 subject to the "hard cap") while at the same time reducing the price of business services. RUCO
10 believed that any price restructuring of residential rates should be revenue neutral only within the
11 residential class of rates and that price restructuring of business services be revenue neutral within the
12 business class, and that without this protection, Qwest could raise residential rates while lowering
13 business rates.

14 RUCO also believed the plan was flawed because it fails to provide separate baskets for
15 services facing various degrees of competition. RUCO claimed the Price Cap Plan denies the
16 Commission the opportunity to classify services in accordance with the subtle nuances of actual
17 market conditions.

18 Staff believed that those advocating additional baskets did not consider that Basket 1 is
19 essentially subdivided into essential services which are subject to the hard cap and non-
20 competitive/non-essential services that are subject to the less stringent pricing rules, including a 25
21 percent limit. Staff claimed that the hard cap on essential services prevented the drastic rate
22 restructuring between business and residential rates of which RUCO warned.

23 We believe that the number of baskets in the Price Cap Plan is appropriate and does not need
24 to be modified at this time.

25 Access Rates

26 AT&T argued that the Plan fails to reduce intraLATA toll switched access rates to a
27 competitive level. AT&T claimed that because Qwest still maintains monopoly power in the local
28 market, Qwest is able to charge substantially more than its cost of providing switched access services

1 and this injures Arizona consumers by inflating the cost of toll services. AT&T notes that although
 2 prior to the Settlement Agreement Staff recommended that Qwest's access charges be reduced to a
 3 level equivalent to interstate access charges, the agreed reduction from approximately \$.045 to \$.033
 4 over three years falls far short of the goal. AT&T advocates that Qwest's intrastate switched access
 5 rates should be reduced to the level of its interstate rates over five years.⁴ Further, AT&T also
 6 charged that the Plan is ambiguous in how the access reductions would occur in the second and third
 7 years of the Plan, and consequently, carriers can not determine how they will be affected.

8 Staff contended that the Plan's reduction of intrastate switched access rates is reasonable in
 9 light of the entire Plan. Staff notes that if access charges are reduced further, rates for other services
 10 would have to be increased to compensate for the lost revenue.

11 Qwest also argued that in advocating parity between intrastate and interstate switched access
 12 charges, AT&T ignores the fact that interstate and intrastate structures are not the same. The
 13 interstate rate structure contains an End User Common Line Charge that generates significant
 14 revenue. In reducing interstate access charges, the FCC has shifted significant revenue requirements
 15 from the carriers to the end user customers.

16 DOD supports the reduction in access charges and urges the parties to make further reductions
 17 with the lost revenue being made up from an End User Common Line charge or a further increase in
 18 the Basket 3 cap.

19 Although the Settlement Agreement professes a goal of reaching parity between Qwest's
 20 intrastate and interstate switched access charges, it does not, at least in its initial three year term reach
 21 that goal. It does, however, take a step forward. While we agree that achieving parity between
 22 intrastate and interstate switched access rates is a laudable goal, there are many other public policy
 23 issues that impact our ability to reach that goal, such as the desirability of imposing an End User
 24 Common Line charge. Such decision concerning the structure of toll service charges should occur in
 25 a generic docket as it affects more than just Qwest. The \$15 million reduction in switched access
 26 revenue is reasonable at this time and in the context of this Settlement Agreement. In approving the
 27

28 ⁴ The proposed interstate rate in the CALLS proposal is \$0.005 cents per minute.

1 Settlement Agreement, the Commission reserves the right to modify the structure of intra-state toll
2 rates.

3 Treatment of New Services and Packages

4 Section 4) e) of the Price Cap Plan provides that a Basket 1 service can become the
5 component of a new service package in Basket 3 as long as the Basket 1 service is combined with at
6 least one Basket 3 service. Any new service or package in Basket 3 is subject to Commission
7 consideration as provided in A.R.S. § 40-250.

8 AT&T, Cox and RUCO claimed that the Price Cap Plan circumvents existing Commission
9 rules by giving Qwest flexible pricing for any new service and for any service presently classified as
10 non-competitive simply by offering the service in a package with a competitive service. Under its
11 current rules (R14-2-1108, and -1109), the Commission grants pricing flexibility to a
12 telecommunications carrier only after the Commission has determined that the carrier lacks market
13 power in the provision of a service.

14 Opponents of the Plan argue that new services should not automatically be placed in Basket 3.
15 Just because a service is new does not mean that competitive alternatives exist. They charge the
16 danger is particularly evident for new services that are ancillary to existing services that are not yet
17 classified as competitive. For example, a new Custom Calling feature that cannot be obtained apart
18 from local exchange service (which is not yet classified as competitive). Customers desiring the new
19 Custom Calling feature would not have sufficient opportunities to obtain the new feature from other
20 providers because it can only be obtained from the carrier who provides dial tone to the customer.
21 Competitors believed the danger of permitting Qwest to bypass Rule 1108, and a specific finding that
22 the service or package is competitive, is exacerbated by the provision permitting flexible pricing in a
23 limited geographic location.

24 They also argue all services or service packages, regardless of whether they are new or not,
25 should meet the requirements of Rule 1108 before they are afforded flexible pricing.⁵ Such treatment
26 would comport with existing Commission rules. Alternatively, Cox argued new services or packages

27 _____
28 ⁵ As written, the Plan provides that if Qwest wants to move a Basket 1 service to Basket 3, it must comply with Rule 1108.

1 should be placed into Basket 1.

2 Cox noted that the Price Cap Plan also modifies Rule 1108 when Qwest requests to move a
3 Basket 1 service to Basket 3 because it sets a six month time period for Rule 1108 determination by
4 Staff. No such time period is set forth in Rule 1108 and this provision of the Price Cap Plan may
5 give Qwest the right to expedited treatment under Rule 1108.

6 Staff and Qwest have agreed to modify the Price Cap Plan by including language in section
7 4)e) that states: "The Commission retains the right to reject any proposed classification or filing."
8 They believe this should alleviate concerns that non-competitive services will find their way into
9 Basket 3. Staff claims that one thing opponents overlook is that pursuant to § 40-250, Qwest must
10 submit tariffs containing any "new services" or "new service packages" to the Commission at least 30
11 days in advance of the proposed effective date. Staff states that one of the things the Commission
12 will be looking at is whether the proposed classification is appropriate or not. Staff believed
13 subjecting new product offerings to the criteria and procedures of A.A.C. 14-2-1108 is counter to
14 consumers' interests. Staff believed that including new services in Basket 3 placed the risk of the
15 failure of the new service on shareholders and not on ratepayers and that allowing a streamlined
16 approval for new services will facilitate the rapid development of new technologies.

17 Staff and Qwest believe they have further clarified their intent with the language in subpart 4)
18 e) ii) that states: "The mere repackaging of existing Basket 1 services does not create a 'new service'
19 or 'new service package' for purposes of the Price Cap Plan." The Plan does not define the term
20 "mere repackaging" and we believe that this language does not add the degree of protection that Staff
21 and Qwest evidently rely on. The Plan permits Basket 1 services to be combined with Basket 3
22 services, but does not provide guidance to Staff when reviewing requests for new services.

23 Despite statements that competitors are protected under the Plan because all of the
24 Commission's rules apply, section 4) e) removes new Basket 3 offerings from the provisions of R14-
25 2-1108. Under Rule 1108 competitors and consumers receive notice of the request and Qwest would
26 have to show the conditions in the relevant market that demonstrate the service is competitive,
27 including the names and number of alternative providers, their ability to make functionally equivalent
28 or substitute services available and other indicators of market power.

1 We recognize the benefits of permitting companies to respond quickly to the market and offer
2 new services rapidly. However, we also want to ensure that our actions encourage rather than stifle
3 competition. Thus, we approve this section of the Settlement Agreement that allows new services
4 and service packages to be included in Basket 3 without having to meet all of the requirements of
5 R14-2-1108, only after modification. We approve this section with the express understanding that in
6 reviewing new service and service package filings, Staff will specifically look at market conditions
7 and whether the service or package is truly competitive, and with the understanding that under A.R.S.
8 § 40-250, Staff may request additional time for its review. The six month time period for a review
9 under Rule 1108 when Qwest requests a Basket 1 service be moved to Basket 3, appears reasonable,
10 however, there may be circumstances when Staff requires additional time for its review. We believe
11 that Staff should have the ability to request additional time from the Commission. Furthermore,
12 given the current early stage of competition, we believe that it is critical that whenever Qwest desires
13 to combine a Basket 1 service with a Basket 3 service, that request should be subject to all of the
14 provisions of a filing under R14-2-1108. Finally, we believe that at least during the initial term of
15 the Plan, that it is in the public interest for Qwest to provide notice to competitors of all new Basket 3
16 filings.

17 Pricing Provisions

18 Basket 1

19 RUCO believed the pricing provisions for Basket 1 are too lax. As originally proposed, the
20 Price Cap Plan provided that prices for non-hard capped services may be increased by up to 25
21 percent for year. At the hearing Qwest clarified that despite the language of the Plan, the intent was
22 for this provision to apply to individual price elements. In their Second Revised Settlement
23 Agreement and Price Cap Plan filed after the hearing, Qwest and Staff changed the language to
24 specify rate elements. Despite the clarification, RUCO believed the permitted increase was still too
25 high.

26 The modified Price Cap Plan alleviates some if not all of RUCO's concerns. In the context of
27 the Settlement Agreement as a whole, the modification is reasonable and should be approved.

28 ...

1 Price Floors for Basket 3 Services

2 AT&T and RUCO argued that the price floor provisions that apply to Basket 3 services
3 undermine competition. The Price Cap Plan creates an exception to the Commission's Imputation
4 Rule (R14-2-1310.C) by allowing the 1FR (flat rate basic residential) to be priced below TSLRIC.
5 Thus, under the Plan, Qwest could combine the 1FR service with any Basket 3 service to create a
6 new package subject to flexible pricing and that package could be priced below TSLRIC. The
7 current 1FR rate is \$13.18. The price competitors pay to purchase the loop as an unbundled network
8 element ("UNE") is \$21.98 on a statewide average. RUCO argued this sort of price squeeze
9 discourages competition for residential customers.

10 AT&T claimed that the pricing floor is ambiguous and that testimony revealed that Staff and
11 Qwest may have different views as to what imputation may be required. It appeared to AT&T that
12 Staff may believe that imputation will be required for features and other essential services. Qwest
13 appears to interpret the Plan as permitting it to price a package containing features at TSLRIC. It also
14 appears Qwest does not believe that originating access is an essential service for purpose of
15 imputation, while Staff believes it is. AT&T charges that the ambiguity will result in the
16 Commission being called upon repeatedly to determine the extent to which Qwest is required to
17 impute its own prices for retail services into the price floor or new packages and services, and such
18 ambiguity is detrimental to competition and contrary to the public interest.

19 Cox recommended that if the Commission believes it is appropriate to keep 1FR at its current
20 retail rate, the Commission can eliminate the anti-competitive effect by prohibiting a new Basket 3
21 service package from including 1FR service or by having the price floor for 1FR packages in Basket
22 3 include the Rule 1310.C amount for 1FR.

23 Cox also argued that neither a TSLRIC nor an imputed price floor recovers all costs of a
24 service because neither one recovers common costs. Cox argued that the appropriate price floor
25 should be at least the imputed price for a particular service, plus an additional amount to cover the
26 common costs attributable to the particular service. Cox proposed an 18 percent markup (which is
27 the current Qwest retail discount to CLECs – an amount that is supposed to represent Qwest's
28 savings on marketing and other retail activities that it need not incur if it is selling service wholesale

1 to a CLEC).

2 Staff believed that the Commission should address concerns relating to the Commission's
3 imputation rules or their application in a separate proceeding. Staff noted that in response to issues
4 raised at the hearing, Staff and Qwest have modified the Price Cap Plan by adding language to
5 subpart 4) e) that the price of the new package or service shall exceed the TSLRIC of the package or
6 service and comply with the imputation requirements of A.C.C. R14-2-1310 (C). Staff and Qwest
7 have also clarified that "For purposes of combining Basket 1 services with Basket 3 services and
8 setting the floor for that package, the imputed price of 1FR service shall be the existing retail price of
9 1FR."

10 DOD agreed that the Commission's imputation rule must be clarified. DOD disagreed with
11 Qwest's interpretation of the imputation rule as to originating access. DOD recommended that the
12 Commission promptly clarify this section of its rules to confirm that originating access is an essential
13 component of retail toll service, and that in any case, for the purpose of this Settlement Agreement,
14 the Commission should specify that originating access is an essential component and subject to
15 imputation.

16 To encourage competition we must resolve any ambiguities in our Rules. Consequently, we
17 are ordering Staff to open a docket to investigate and rectify possible ambiguities involving the
18 pricing of telecommunication services and imputation in particular. In the meantime, until the
19 Commission has made a final determination regarding Rule 1310, for purposes of this Settlement
20 Agreement, we require that originating access be considered an essential component of retail toll
21 service.

22 Geographic Pricing

23 Subpart 4) g) of the Price Cap Plan allows "[n]ew services and packages in Basket 3 . . . [to]
24 be offered to selected customer groups based on their purchasing patterns or geographic locations, for
25 example. This provision shall not be construed to permit red-lining based on criteria such as wealth
26 or race, or to permit Qwest to discriminate against any class of customers in violation of A.R.S.
27 Section 40-334." Section 40-334 prohibits any unreasonable difference as to rates, charges, services,
28 service facilities or in any other respect, either between localities or between classes of service.

1 AT&T and Cox argued that section 4) g) permits Qwest to undercut prices of services offered
2 by competitors in limited geographic areas where Qwest faces competition while maintaining its
3 monopoly profit margin in other areas. As written, they claim section 4) g) allows Qwest to target
4 areas for flexible pricing even if there is little or no competition in those areas. There is no minimum
5 size for the geographic location and it appears that new services and service packages may be
6 approved under section 4) g) without consideration of the level of competition within the geographic
7 location. Cox and AT&T argued this results in giving Qwest the ability to spot price and to quash
8 emerging competition in particular areas. Higher prices for the services in areas with no competition
9 will subsidize the lower rates in select areas.

10 Cox compared the section 4) g) provisions to the "competitive zone" proposal which Staff's
11 consultants criticized prior to negotiating the Settlement Agreement. Under the "competitive zone"
12 proposal, Qwest would be allowed to have flexible pricing for all services offered in a particular wire
13 center provided there were other competitors who could serve that wire center, regardless of whether
14 they were actually serving the wire center in any significant way. Under Qwest's proposal, it would
15 not have to meet the requirements of Rule 1108 to flexibly price in a competitive zone.

16 Prior to the Settlement Agreement, Staff had taken the position that whatever regulatory
17 structure is adopted, it should include a requirement that prices in different geographic areas may not
18 vary by an amount that is greater than the variation that is justified by any variation in the cost of
19 providing service.

20 Cox argued that if section 4) g) remains in the Plan, terms such as "selected customer groups"
21 "purchasing patterns" and "geographic location" need further explanation and definition. For
22 example, could geographic location constitute a single office building? AT&T and Cox believe that
23 the supposed protections offered by reference to A.R.S. § 40-334, are toothless, and essentially
24 abrogated by section 4) g).

25 Staff disagreed and believed that A.R.S. § 40-334 will prevent the anticompetitive behavior
26 about which Cox and AT&T complain. Staff argues that A.R.S. § 40-334(a) expressly prohibits the
27 granting of any preference or advantage to any person or subjecting any person to any prejudice or
28 disadvantage. Further, Staff states, § 40-334(b) expressly prohibits any public service corporation

1 from establishing or maintaining any unreasonable differences as to rates, charges, service, facilities
2 or in any other respect between localities or between classes of service. Subpart (c) vests the
3 Commission with the responsibility to determine any question of fact arising under the section. Staff
4 claims that all offerings under section 4) g) must be submitted to the Commission at least 30 days in
5 advance of their going into effect, and that any inappropriate classification or anticompetitive pricing
6 which Qwest may attempt to engage in on a limited geographic basis would result in Commission
7 denial.

8 Qwest argued the Settlement Agreement does not mirror the proposed competitive zone plan
9 in its original rate case application. Under its competitive zone proposal, all services in Qwest's
10 Phoenix and Tucson wire centers would have been flexibly priced. The price cap established for
11 these competitive zones permitted a 100 percent ceiling above Qwest's existing rates and, in effect,
12 would allow Qwest to double its prices. Qwest notes that under the Price Cap Plan there is a hard cap
13 on essential services in Basket 1 and a ceiling of ~~40~~ 13.4 percent in the aggregate for Basket 3
14 services. Furthermore, all services in Basket 3 have already been determined to be competitive or
15 flexibly priced by the Commission.

16 Staff's assurances do not provide sufficient comfort to over-ride our concerns about Qwest's
17 ability to price a competitive service very aggressively in a targeted area, but be able to price the
18 same service or package much higher in areas where it doesn't face competition. At this time, we
19 find ourselves agreeing with Staff's original position taken in response to Qwest's competitive zone
20 proposal. Before we can approve the concept of geographic pricing variances, we believe that terms
21 describing when, where and to whom such services may be offered need more definition. Given the
22 apparent opposition between what section 4) g) allows and what A.R.S. § 40-334 prohibits, we
23 believe the Commission will be subjecting itself to resolving numerous complaints. Consequently,
24 this section should be removed from the Price Cap Plan. In the future, the parties may be able to
25 fashion a provision that allows Qwest to compete in areas where it truly faces established
26 competition, but such provision must better describe the geographic areas and population served as
27 well as promote specific and clear protections against anti-competitive behavior.

28 ...

Service Quality

RUCO did not believe that the Price Cap Plan provides adequate protections against further service quality deterioration, but rather gives Qwest greater incentive to sacrifice service quality for higher profits. AT&T proposed modifying the service quality protections to provide that Qwest must maintain service quality levels at a minimum to those prevailing immediately preceding adoption of the Plan, or the Commission could impose penalties or fines or terminate the price cap plan and reinstate rate-of-return regulation.

We believe the increased penalties in combination with the relatively short term of the Plan should be sufficient incentive for Qwest to maintain or improve service quality. The term of the Plan is not so long that the Commission will not be able to stiffen penalties for persistent service quality declines in the near future.

Notice and Opportunity for Commission Review

Cox expressed concern about the ability of Staff and interested parties to monitor Qwest price floors. The Price Cap Plan is silent on how often Qwest must file TSLRIC cost studies or other price floor calculations with the Commission and it does not contemplate any particular follow-up to consider updated cost studies or price floor calculations after a new service or package is approved. Cox believed the lack of such review process or standard undermines the effectiveness of the Price Cap Plan from stopping cross-subsidies or predatory pricing.

Opponents of the Settlement Agreement were concerned that the Settlement Agreement did not contain a provision that required notice to consumers or competitors of proposed changes for Basket 1 services or for the filing of proposed new services or new service packages for Basket 3. Cox believed this lack was contrary to the policies expressed in R14-2-1108 which required notice to competitors any time a telecommunications company seeks to have its services deemed competitive and subject to flexible pricing.

AT&T believes it is even more critical that competitors receive notice of new service and package filings because Staff only has a 30 day time frame for its evaluation. AT&T argued that input from competitors is critical to Staff's analysis of anti-competitive pricing. Because AT&T did not believe that Owest's cost studies should be accepted at face value, other carriers should receive

1 notice of proposed new service offerings and the review time should be extended to 60 days to insure
2 that Qwest is in compliance with all existing Commission rules.

3 We believe that our modification of the Settlement Agreement regarding the approval of new
4 services addresses the parties' main concerns about notice, and that no further modification is
5 required. We are concerned that Staff have sufficient time and information to make
6 recommendations concerning new services. Thus, we believe Staff should retain the ability to
7 request extensions of any of the review deadlines established in the Plan.

8 "No Refund" Provision

9 RUCO argued the Commission should reject the Settlement Agreement because the provision
10 that excuses Qwest from paying refunds in the event the Price Cap Plan is determined by a court to be
11 unlawful is contrary to Arizona law. RUCO recommended that the Commission should order a
12 refund upon a successful appeal unless doing so would be unjust in the particular circumstances of
13 the case. RUCO did not think the Commission could make such conclusion at this time.

14 Staff defended this provision of the Settlement Agreement, stating that the Price Cap Plan
15 provides for a wide range of changes in rates for specific services, some of which go up, and some of
16 which go down. Staff believed it would be prohibitively difficult and costly to calculate and
17 administer a refund in the event the Price Cap Plan were found to be unlawful. Further, Staff noted,
18 fairness would seem to dictate that some ratepayers would be entitled to refunds, but others, whose
19 rates went down under the Plan, would be required to pay a surcharge.

20 In such a situation, the Commission has discretion to determine if refunds should be required.
21 For the reasons Staff cites, we believe this provision is reasonable in this circumstance. The most
22 vulnerable ratepayers, the captive residential consumers are protected from rate increases under the
23 terms of the Price Cap Plan.

24 Procedural Challenges

25 RUCO claimed that the Commission acted unfairly by admitting the pre-filed testimony that
26 had been filed prior to the filing of Settlement Agreement but limiting the scope of the hearing to the
27 Settlement Agreement and not allowing cross examination of the prior testimony. RUCO argued that
28 the Commission must evaluate the Settlement Agreement, in part, by evaluating the entire record, but

1 that the Commission cannot base its decision on evidence on which it has not permitted the parties to
2 cross examine.

3 It is not unusual in the context of a settlement for the Commission to limit the hearing to the
4 issue of the Settlement Agreement. The parties have had adequate opportunity to present their
5 positions and to cross examine witnesses on the terms of the Settlement Agreement and Price Cap
6 Plan. Although we have evaluated the Settlement Agreement in the context of the entire rate
7 proceeding, the parties were not unfairly prejudiced by limited cross examination of testimony filed
8 prior to the Settlement Agreement.

9 As modified herein, we believe the Settlement Agreement and Price Cap Plan between Staff
10 and Qwest takes a step along the road to competition and provides benefits to the consumers of
11 Arizona.

12 * * * * *

13 Having considered the entire record herein and being fully advised in the premises, the
14 Commission finds, concludes, and orders that:

15 **FINDINGS OF FACT**

16 1. Qwest filed an application for an increase in rates with the Commission on January 8,
17 1999.

18 2. Our Procedural Order dated March 4, 1999, established a schedule for filing testimony
19 and set a hearing for November 4, 1999.

20 3. In October 1999, Qwest and Staff filed a joint motion to continue the procedural dates
21 pending resolution of Qwest's pending depreciation case (Docket No. T-1051-97-0689).

22 4. A Procedural Order filed January 7, 2000, continued the hearing pending resolution of
23 the depreciation docket and suspended the time clock rules.

24 5. In January 2000, Staff filed a Motion for Qwest to update the test year. A Procedural
25 Conference was held on April 4, 2000 and Qwest was directed to re-file its schedules using a
26 calendar year 1999 test year.

27 6. Qwest filed updated testimony on its revenue requirement and rate of return on May 3,
28 2000, and updated testimony on rate design, cost studies and RCND on May 19, 2000.

1 7. Our Procedural Order filed May 5, 2000, set dates for filing testimony and scheduled a
2 hearing for September 25, 2000. Our July 27, 2000 Procedural Order set revised dates for filing
3 testimony of all parties.

4 8. Intervention was granted to AT&T, RUCO, MCI WorldCom, Cox, Rhythm Links
5 Communications, e-spire Communications, DOD, Sprint Communications, CWA, Citizens
6 Communications Company, TDS Telecommunications Corp., One Point Communications-Colorado
7 LLC, Ed McGillivray, ACI Corp. dba Excellerated Connections, Inc., Cable Plus Co. dba Telephone
8 Plus, Valley Telephone Cooperative, Copper Valley Telephone, Teligent Inc., GCB
9 Communications, Inc., Arizona Dialtone, Inc., Arizona Consumers Council, Telephone Retiree
10 Association-Arizona, Excell, Cable Plus Telecommunications and the Town of Gila Bend.

11 9. Public Comment sessions were held in Flagstaff, Prescott, Payson, Globe, Phoenix,
12 Tucson, Bisbee, Sierra Vista and Yuma throughout June, July and September, 2000.

13 10. On August 9, 2000, Staff, RUCO, AT&T, Cox, APA and DOD filed direct testimony.

14 11. On August 21, 2000, Qwest filed rebuttal testimony.

15 12. On September 8, 2000, Staff, RUCO, AT&T, Cox, APA and DOD filed surrebuttal
16 testimony.

17 13. On September 19, 2000, Qwest filed rejoinder testimony.

18 14. On September 19, 2000, Staff and Qwest filed a motion to continue the hearing
19 pending discussions on possible settlement.

20 15. By Procedural Orders dated October 4, and October 17, 2000, the hearing was
21 continued until November 29, 2000.

22 16. On October 20, 2000, Qwest and Staff filed a Settlement Agreement addressing all of
23 the issues raised in the rate case.

24 17. On October 27, 2000, Qwest, Staff and CWA filed direct testimony on the Settlement
25 Agreement.

26 18. On November 8, 2000 and November 13, 2000, RUCO, AT&T, Cox and the DOD
27 filed direct testimony on the Settlement Agreement. On November 15, 2000, RUCO filed additional
28 direct testimony on the Settlement Agreement.

1 19. On November 20, 2000, Qwest and Staff filed rebuttal testimony on the Settlement
2 Agreement.

3 20. On November 28, 2000, the ~~American~~ **Arizona** Payphone Association filed testimony
4 in support of the Settlement Agreement *and setting forth the public access lines rates for the time of*
5 *the initial term of the Rate Proceeding Moratorium Period agreed to by Qwest and the APA,*
6 *contingent upon the approval of the Settlement Agreement. A copy of the agreed upon public*
7 *access lines rates are attached hereto as Exhibit B, and incorporated herein by reference.*

8 21. Commencing November 29, 2000, through December 4, 2000, the Commission
9 conducted a hearing to consider the Settlement Agreement. Public comment on the Settlement
10 Agreement was heard prior to the commencement of the evidentiary proceeding.

11 22. On December 18, 2000, Qwest, Staff, AT&T, RUCO, Cox and DOD filed post-
12 hearing briefs.

13 23. On December 18, 2000, Staff and Qwest filed a revised Settlement Agreement that
14 incorporated language clarifications that had been discussed during the hearing.

15 24. On December 26, 2000, Staff and Qwest filed a Second Revised Settlement
16 Agreement and Price Cap Plan. A copy of the Second Revised Settlement Agreement and Price Cap
17 Plan is attached hereto as Exhibit A, and incorporated herein by reference.

18 25. On January 8, 2001, AT&T filed a Reply to Price Cap Plan Revisions of Staff and
19 Qwest.

20 26. The Settlement provides that Qwest's fair value rate base for the test year ending
21 December 31, 1999, is \$1,446.0 million and a reasonable rate of return on that rate base is 9.61
22 percent.

23 27. For rate making purposes the Settlement Agreement provides that Qwest's revenue
24 requirement deficiency in Arizona is ~~\$42.9~~ \$23.3 million.

25 28. Under the terms of the Settlement Agreement, Qwest's rates would be determined
26 pursuant to the Price Cap Plan.

27 29. Under the Second Revised Settlement Agreement and Price Cap Plan, consumers
28 benefit from rate reductions of certain non-competitive services, the hard price cap on essential basic

1 services, lower switched access rates and from increased incentives on Qwest to improve service
2 quality.

3 30. To insure the Commission has complete information when reviewing new services and
4 service packages, it is reasonable to require Qwest to provide notice to competitors when it files to
5 include a new service or service package in Basket 3.

6 31. Pursuant to section 4) e) of the Price Cap Plan, it is reasonable for the Commission to
7 retain the right to reject any proposed classification of a new service or package and that such review
8 shall include an analysis of the competitive market for the particular service or package at issue.

9 32. In reviewing new service offerings pursuant to section 4) e), 4) i) and A.R.S. §40-250,
10 Staff may request an extension of the prescribed time periods.

11 33. Because competition in many markets is in its infancy, it is reasonable to modify the
12 Settlement Agreement and Price Cap Plan to provide that if Qwest desires to combine a Basket 1
13 service with a Basket 3 service and to include the package in Basket 3, Qwest must comply with
14 A.A.C. R14-2-1108.

15 34. Section 4) g) of the Price Cap Plan is vague and ambiguous and should be removed
16 from the Price Cap Plan.

17 35. It is in the public interest for the Commission to rectify any ambiguities associated
18 with the pricing of telecommunication services, and specifically the interpretation of R14-2-1310(C).

19 36. Pending the clarification of the Commission's imputation rule, it is reasonable to
20 include originating access as an essential element of toll service.

21 CONCLUSIONS OF LAW

22 1. Qwest is a public service corporation within the meaning of the Arizona Constitution,
23 Article XV, and under Arizona Revised Statutes, Title 40, generally.

24 2. The Commission has jurisdiction over Qwest and the subject matter of this
25 proceeding.

26 3. Notice of the application and subsequent proceeding was provided in the manner
27 prescribed by law.

28 4. The Second Revised Settlement Agreement and Price Cap Plan, as modified herein,

1 are just and reasonable and in the public interest and should be approved.

2 5. *The public access lines rates set forth in Exhibit B are just and reasonable and*
3 *should be approved.*

4 **ORDER**

5 IT IS THEREFORE ORDERED that the Second Revised Settlement Agreement and Price
6 Cap Plan shall be modified as discussed herein and set forth in Findings of Fact Nos. 30, 31, 32, 33
7 and 34.

8 IT IS FURTHER ORDERED that the Second Revised Settlement Agreement and Price Cap
9 Plan, as modified herein, is hereby approved.

10 ***IT IS FURTHER ORDERED that the public access lines rates set forth in Exhibit B are***
11 ***hereby approved.***

12 IT IS FURTHER ORDERED that Qwest Corporation shall file tariffs consistent with the
13 Second Revised Settlement Agreement and Price Cap Plan, as modified herein, no later than
14 February 28, 2001.

15 IT IS FURTHER ORDERED that the rates and charges approved herein shall be effective for
16 all services billed on and after March 1, 2001.

17 IT IS FURTHER ORDERED that Qwest Corporation shall notify its customers of the rates
18 and charges authorized herein and the effective date of the same within 30 days of the effective date
19 of this Decision. This requirement does not modify Qwest Corporation's obligation to provide notice
20 pursuant to the Second Revised Settlement Agreement. Qwest Corporation shall provide copies of
21 the notice it intends to provide to its customers to Commission Utilities Division Staff for approval
22 prior to sending such notice(s).

23 ...

24 ...

25 ...

26 ...

27 ...

28 ...

1 IT IS FURTHER ORDERED that Commission Staff shall open a docket to investigate and
2 rectify any ambiguities associated with the pricing of competitive telecommunication services,
3 specifically, but not limited to, R14-2-1310(C).

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.
6
7

8 CHAIRMAN

COMMISSIONER

COMMISSIONER

9
10 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
11 Secretary of the Arizona Corporation Commission, have
12 hereunto set my hand and caused the official seal of the
13 Commission to be affixed at the Capitol, in the City of Phoenix,
14 this ____ day of _____, 2001.

15 _____
BRIAN C. McNEIL
EXECUTIVE SECRETARY

16 DISSENT _____
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1 SERVICE LIST FOR:

QWEST CORPORATION

2 DOCKET NOS.:

T-01051B-99-0105 and T-01051B-00-0369

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SETTLEMENT AGREEMENT

Qwest Corporation (Qwest) and the Arizona Corporation Commission Staff (Staff) (collectively "the Parties") hereby agree to a settlement (the "Agreement") of the pending Qwest general rate case in Docket No.T-01051B-99-0105 (the Rate Case). The following terms and conditions, including Attachments (A) through (E) appended hereto (hereinafter referred to as the Price Cap Plan), are intended to resolve all of the issues among the Parties associated with the Rate Case.

RECITALS

WHEREAS, the Parties desire to adopt this Agreement and Price Cap Plan for Qwest to create incentives for Qwest to improve its efficiency, to provide new and innovative service offerings and to reduce the opportunity for cross-subsidization of competitive services by non-competitive services.

WHEREAS, by adopting the Price Cap Plan, the Parties intend to avoid the need for any general rate proceeding for the next three years, provide rate stability to Qwest's Arizona consumers by capping rates for essential services and create an opportunity for Qwest's customers to benefit from productivity improvements in the form of decreased rates.

WHEREAS, the Parties agree that the price caps provided for in this Agreement will ensure that rates for Qwest's telecommunications services are based on the fair value of Qwest's property devoted to the provision of intrastate telecommunications services in Arizona and to result in the establishment of just and reasonable rates for Qwest's Arizona customers; and

WHEREAS, the Parties agree that nothing in this Agreement is intended to in any way restrict or modify the Commission's current authority or jurisdiction over Qwest as provided under Arizona law; and

WHEREAS, the Parties agree that this Settlement is in the public interest.

TERMS

1. FAIR VALUE RATE BASE AND REASONABLE RATE OF RETURN. For ratemaking purposes and in accordance with the terms of this Agreement, the Parties agree that the "fair value" of Qwest's Arizona rate base for the test year ending December 31, 1999 (the "Test Year") is \$1,446.0 million. For ratemaking purposes and in accordance with the terms of this Agreement, the Parties agree that a reasonable return on the fair value of that rate base is 9.61%. The Parties stipulate to the adoption of the foregoing fair value rate base and reasonable rate of return and agree that the resultant increased revenue requirement, as identified in Section 2 below, results in just and reasonable rates for Qwest.

2. REVENUE REQUIREMENT DEFICIENCY. For ratemaking purposes and in accordance with the terms of this Agreement, the Parties agree that Qwest's jurisdictional revenue requirement deficiency is \$ ~~42.9~~23.3 million.

3. RATE DESIGN. The Parties agree that the revenue requirement set forth in Section 2 above shall be recovered through ~~(a) a combination of increases and~~(a) decreases in rates for services reflected on Attachment B hereto ~~to recover in the amount of \$ 17.6~~in the amount of \$ 19.4 million of Qwest's Test Year revenue requirement and (b) the opportunity for revenue from flexibly-priced services contained in Basket 3 of the Price Cap Plan discussed in Section 4 of this Agreement to recover ~~\$25.3~~42.7 million of Qwest's Test Year revenue requirement. The initial rates set forth on Attachment B include rate adjustments based on Test Year revenue levels as follows:

<u>\$ Million</u>	
23.1	Increase revenues from directory assistance rates
	which shall be capped at \$ 0.85 per call for one
	year
13.7	Increase in Private Line Services
-5.0	Reduction in Intrastate Access Charges for First Year of Agreement
-7.98.1	Reduction in Residential Basic Service Nonrecurring
	Charges from \$ 46.50 to \$ 35.00
-1.5	Revenue Reduction from Basic Residential Service from Change in U-1 Base Rate Area Boundaries
-1.9	Revenue Reduction from Basic Residential Service from Change in U-2 Base Rate Area Boundaries
-2.3	Elimination of Residential Non-recurring Zone Connection Charge
-0.2	Elimination of Business Non-Recurring Zone Connection Charge
-0.2	Revenue Reduction from Basic Business Service From Change in U-1 Base Rate Area Boundaries
-0.2	Revenue Reduction from Basic Business Service From Change in U-2 Base Rate Area Boundaries
<u>17.6-19.4</u>	Overall Immediate Revenue Change
<u>25.342.7</u>	Increase in available additional revenue in Basket 3
	services except directory assistance for one year
<u>42.923.3</u>	Overall Net Revenue Change Authorized

The Parties further agree that rates for Intrastate Switched Access Service shall be reduced at the start of the second year of the Price Cap Plan to cause an additional \$ 5 million reduction in revenues from that service and reduced again at the start of the third year of the Price Cap Plan to cause an additional \$ 5 million reduction in revenues. The Parties agree that the revenues available under the Cap for Basket 3 Services, as described in the next Section of this Agreement, shall be increased by \$ 5 million at the start of the second year of the Price Cap Plan and an additional \$ 5 million at the start of the third year of the Price Cap Plan to correspond on a revenue requirement basis to the reduction in access revenues.

The Parties agree that Qwest's Due Date Change Tariff and Start-Up Package Elimination Tariff may be implemented upon Commission approval of this Agreement. The

Parties also agree that all multi-party grades of residential and business basic service should be eliminated. The net effect of the approval of these tariffs and the elimination of multi-party service is to increase Qwest's revenues by \$247,856 and to require investment of approximately \$4 million. These amounts are in addition to the amount set forth in section 2 as the change in revenue requirement.

4. PRICE CAP PLAN. The Parties agree to create a Price Cap Plan, described in this Section and Attachments (A) through (E) appended hereto, as part of the resolution of the Rate Case. The term of the Price Cap Plan shall be three years from the effective date as specified in the Commission's Order approving this Agreement and Price Cap Plan. The Parties agree that the initial rates set forth on Attachment B and the flexibility for Basket 3 Services under the Price Cap Plan result in just and reasonable rates for Qwest's Arizona intrastate operations. Upon approval of this Agreement by the Commission, Qwest will file its intrastate tariffs in accordance with this Agreement, which rates shall take effect as specified in the Commission's order approving of this Agreement and Price Cap Plan.

The Price Cap Plan creates three "baskets" of services. Basket 1 consists of Basic/Essential Non-Competitive Services. The services in Basket 1 are identified on Attachment C to this Agreement. Basket 1 will be capped, using an "Inflation minus Productivity" indexing mechanism, subject to annual updates in the quantity of demand as set forth on Attachment A. As a compromise to the respective positions of the parties, the productivity factor (X) for the initial term of the Plan is set at 4.2%, which includes a 0.5% consumer dividend. The productivity offset for each year of the initial term applied to the Price Index cap for Basket 1 shall be equal to $(\text{GDP-PI}) - X$, where zero is equal to or greater than $-(\text{GDP-PI}) - X$. The parties agree to conduct studies and submit productivity evidence in the

scheduled review of the Plan's initial term. Basket 2 consists of Wholesale Services. The services in Basket 2 are identified on Attachment D to this Agreement. Except as otherwise provided in this Agreement, services in Basket 2 will be capped at the levels existing on the date of execution of this Agreement and will remain subject to the specific pricing rules for those services, as interpreted by the Commission and the Courts. Basket 3 consists of Flexibly-Priced Competitive Services. The Services contained in this Basket are identified on Attachment E to this Agreement. Basket 3 will be capped at an index, subject to annual updates in the quantity of demand, which index will be calculated as set forth in subpart 4(c) of Attachment A. Notwithstanding, the additional revenue level for purposes of headroom in Basket ~~3-3~~ shall be capped at \$~~25.3~~42.7 million, on a test year basis, for the term of the Price Cap Plan. Basket 3 will also be subject to an upward adjustment of \$5 million per year in the second year of the Price Cap Plan and an additional \$5 million per year in the third year of the Price Cap Plan to offset the annual reductions to intrastate switched access revenue under this Agreement. The details of the Price Cap Plan and the procedural mechanisms for the implementation of price changes under that Plan are set forth on Attachment A to this Agreement.

Nine months prior to the expiration of the Price Cap Plan, Qwest will submit an application with its recommendation for extension, or revision of the Price Cap Plan for review by Staff, the Residential Utility Consumer Office ("RUCO") and the Commission. The Application will be available for review and comments by other interested parties. The Application will include the following information:

- a. A detailed statement of price and revenue changes effected during the initial term of the Price Cap Plan;

- b. A statement of the aggregate investment and retirements in plant, and associated depreciation for the preceding calendar year;
- c. A statement of the operating income and return on investment for the preceding calendar year;
- d. Service quality comparative data during the initial term of the Price Cap Plan as specified by Staff; and
- e. Updated analysis of productivity data applicable to the Price Cap Plan.

Staff may request and Qwest will provide, pursuant to A.R.S. § 40-204, such other additional information as Staff determines necessary for the analysis of Qwest's application. Staff agrees to withdraw its recommendation concerning a plant modernization credit, subject to a review of Qwest's capital investment during the initial term of the Price Cap Plan.

Renewal or modification of the Price Cap Plan at the end of the initial term is subject to approval by the Commission. Until the Commission approves ~~the~~ a renewal or modified Price Cap Plan, or orders a termination of the Plan after its term, the Plan including the hard caps on Basket One Services set forth in paragraph 2(c)(i) shall continue in effect.

The Parties further agree that if the Federal Communications Commission ("FCC") or the Commission orders, adjusts or raises an assessment for the support of Universal Service during the initial term of the Price Cap Plan, the recovery of that assessment is not subject to the provisions of the Price Cap Plan and Qwest may pass through that assessment in the form of a surcharge(s) without filing a general rate case. Any additional federal or state universal service funding received by Qwest will be considered an adjustment to the price caps established under this Plan.

5. SERVICE QUALITY CREDITS. To ensure service quality during the initial term of the Price Cap Plan, the Parties agree that, for any year in which Qwest becomes subject to penalties under two or more of the five categories defined in Section 2.6 of the Service Quality Plan Tariff [i.e., Section 2.6.1(E) through Section 2.6.1(F)], additional credits shall be implemented after each of the initial three Price Cap Plan years if existing penalties are payable. Such additional credits shall take the form of one-time credits of \$2.00 for each residential and business access line in Arizona. Qwest shall issue these credits no later than March 31 of the year in which the foregoing Section 2.6 penalties are paid. The foregoing credits are additional to any credits and penalties provided by the Service Quality Plan Tariff. No service quality penalties or credits shall be assessed during the initial term of the Price Cap Plan other than those provided for in the Service Quality Plan Tariff as modified by Decision No. 62672 and in this Agreement, except for any wholesale standards and penalties adopted in Docket No. T-00000B-97-0238 or in any other Commission proceeding addressing wholesale service quality standards or ~~penalties~~penalties.

6. NOTICE TO CONSUMERS. Following Commission approval of the Settlement Agreement and Price Cap Plan, Qwest will provide, in two subsequent bills sent to Qwest's Arizona consumers, information regarding the services for which rates and charges may change without Commission approval. The bill inserts shall also inform Qwest's customers that essential basic services which are part of any packaged offering remain available and can be obtained by the customer as a separate offering. The bill inserts shall also inform consumers that the Arizona Corporation Commission remains the regulatory agency responsible for overseeing the terms, conditions, rates and quality of service provided by Qwest and that complaints regarding any of Qwest's regulated services should be directed to the Commission's Consumer Services Section.

The bill inserts will be provided to Staff for its review and approval prior to being sent to consumers. In connection with the implementation of this Agreement, Qwest will prepare training materials for customer service representatives to use in interfacing with customers in conjunction with the implementation of the Price Cap Plan.

7. MORATORIUM ON AND PROCEEDINGS FOR FUTURE RATE INCREASES. The Parties agree that no Party shall file an application for or complaint seeking an adjustment in Qwest's general rates and charges that would be effective during the initial term of the Price Cap Plan (the "Rate Proceeding Moratorium Period"). The Rate Proceeding Moratorium Period shall be extended for each additional period of extension or revision of the Price Cap Plan.

8. COMMISSION APPROVAL AND SEVERABILITY. Each provision of this Agreement is in consideration and support of all other provisions, and expressly conditioned upon acceptance and approval by the Commission without material change. Unless the Parties to this Agreement otherwise agree, in the event that the Commission fails to accept and approve this Agreement according to its terms, then it shall be deemed withdrawn by the Parties and the Parties shall be free to pursue their respective positions in the Rate Case without prejudice.

9. COMPROMISE. This Agreement represents the Parties' mutual desire to compromise and settle disputed claims and issues regarding the prospective just and reasonable rate levels of Qwest in a manner consistent with the public interest and based upon the pre-filed testimony, and exhibits and the evidentiary record developed in the Rate Case. This Agreement represents a compromise of the positions of the Parties. Acceptance of this Agreement is without prejudice to any position taken by any party in the Rate Case and none of the positions taken herein by any of the Parties may be referred to, cited or relied upon by any other party in any fashion as

precedent or otherwise in any proceeding before this Commission or any other regulatory agency or before any court of law for any purpose except in furtherance of the purposes and results of this Agreement.

10. PRIVILEGED AND CONFIDENTIAL COMMUNICATIONS. All negotiations relating to or leading to this Agreement are privileged and confidential, and no party is bound by any position asserted in negotiations, except to the extent expressly stated in this Agreement. As such, evidence of conduct or statements made in the course of negotiation of this Agreement are not admissible as evidence in any proceeding before the Commission, any other regulatory agency or any court.

11. COMPLETE AGREEMENT. This Agreement represents the complete agreement of the Parties. There are no understandings or commitments other than those specifically set forth herein. The Parties acknowledge that this Agreement resolves all issues that were raised in the Rate Case and is a complete and total settlement between the Parties.

12. SUPPORT AND DEFEND. Each Signatory Party will support and defend this Agreement and any order entered by the Commission approving this Agreement before the Commission or other regulatory agency or before any court in which it may be at issue.

13. APPEALS AND CHANGE OF LAW. The Parties hereto believe that the Settlement Agreement and Price Cap Plan provided for herein are lawful and consistent with the Arizona Constitution and case law interpreting the Arizona Constitution. If the Arizona courts should ultimately find, in a final, nonappealable order, that the Price Cap Plan is unlawful, or there is other significant change in controlling federal and state law, Staff and Qwest shall review the court decision or other change in law and discuss whether the Plan can be modified to meet the

order or change in law. Further, Qwest shall have no obligation to refund revenues collected during the period of time the Price Cap Plan is in effect. If Staff and Qwest are unable to reach an agreement on how to modify the Price Cap Plan, the Plan shall end, and the Commission shall determine the appropriate method of regulation for Qwest.

DATED this 20th day of October, 2000.

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION STAFF

BY: _____
Deborah Scott, Director

QWEST CORPORATION

BY _____
Teresa Wahlert, Arizona Vice-President

Draft - for March 22, 2001 Open Meeting
Attachment A:
Terms, Conditions and Operation of the Price Cap Plan

Price Cap Plan

- 1) Baskets
 - a) Basket 1: Basic/Essential Non-competitive Services
 - b) Basket 2: Wholesale Services
 - c) Basket 3: Flexibly-Priced Competitive Services
- 2) Basket 1: Basic/Essential Non-competitive Services
 - a) A list of the individual services in Basket 1 is appended hereto as Attachment C.
 - b) Cap on Basket 1
 - i) The Arizona Corporation Commission ("Commission") Staff recognizes the advantages of an "Inflation minus Productivity" price cap index mechanism. Given the uncertainty of recent interpretations of Arizona law regarding rate increase mechanisms, for the initial three year term of the plan, the weighted average price level (or "Price Index") of all services contained in Basket 1 is capped, using an "inflation minus productivity" indexing mechanism, subject to annual updates in the quantities of demand for each service.
 - ii) The Productivity Offset, which is the X Factor in the formula in subpart 2 b) vi) below, shall be equal to 4.2 percent.
 - iii) The measure of inflation used in the Price Cap Index mechanism is the annual percent change in the Gross Domestic Product Price Index ("GDP-PI"), using a seasonally-adjusted, chained price index, as calculated by the Department of Commerce. The percent change in the GDP-PI from the most recently available quarter and the same quarter from the previous year, shall be the basis for the calculation of inflation in the Price Cap Mechanism. The "Inflation minus Productivity" calculation shall be performed once annually on January 1st.
 - iv) The "Inflation Minus Productivity" calculation shall be capped at zero and has no lower bound. Therefore, the Price Cap Index is capped at 1.00 and has no lower bound.
 - v) In the first quarter of the third year of the Price Cap Plan, Qwest shall file, along with other required materials, productivity evidence for the past 2 years under price regulation.
 - vi) The formula for the Price Cap Index for Basket 1 is:

$$1.00 + \% \Delta \text{GDP-PI} - \text{X Factor} \geq [\text{SUM } [P_N * Q_b]] / [\text{SUM } [P_b * Q_b]]$$

The numerator of the Price Cap Index of Basket 1 is the sum of the proposed/new prices multiplied by the "base year" quantities of demand. Where price changes have not occurred, the base year price of the service is used. The denominator is the sum of base year prices multiplied by the "base year" quantities of demand. Section (5) below details the data that Qwest shall provide to enable calculation and monitoring of the cap.

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Attachment A:
Terms, Conditions and Operation of the Price Cap Plan

With each price change, Qwest must provide the existing and new price to Staff, as well as Qwest's calculation of the Price Index following implementation of the price change. Staff will use the Price Cap Database to check Qwest's calculation. All price changes must be demonstrated to be within the cap. The Price Cap Index calculation will be cumulative in a given year.

- c) Service Pricing Flexibility
 - i) Certain Basic services are to be capped at their initial levels throughout the term of the Price Cap Plan. These service prices may be reduced as they are included in the calculation of the Basket 1 Price Index. These services are: flat rate residential; flat rate business; 2 & 4 party service; exchange zone increment charges; low use option service; service stations service; telephone assistance programs; individual PBX Trunks, including features; Caller ID block; toll blocking; 900/976 blocking; and basic listing service.
 - ii) The remaining services in Basket 1 may increase or decrease within the band established by the Price Index.
 - iii) Individual service rate elements within Basket 1, other than those services listed in subpart i) above [services subject to the hard cap], may increase no more than 25 percent within a year.
 - iv) Individual service prices must exceed the service's Total Service Long Run Incremental Cost ("TSLRIC"), unless a different cost standard applicable to all telecommunications service providers is determined appropriate by the Commission. Individual service prices must also comply with the imputation requirements of A.A.C. R14-2-1310(c), as applicable.
 - v) Changes to Terms and Conditions of services in Basket 1 shall be submitted to the Commission for Staff review and approval. All services in this Basket shall be continued statewide at the tariffed rate, unless or until the Commission orders retail geographic rate de-averaging, or unless Qwest demonstrates a cost difference for a new service on which to base the price difference. Nothing in this Price Cap Plan shall preclude the Commission from deaveraging wholesale rates on a cost basis.
 - vi) Price increases for services in this Basket require 30 day notice to the Commission by submission to Staff, and 30 days notice to consumers.
- 3) Basket 2: Wholesale Services
 - a) The services included in Basket 2 at the Price Cap Plan's inception include: Intrastate Carrier Switched Access, Discounted Wholesale Offerings, Unbundled Network Element (UNE) Offerings, Wholesale services such as PAL lines, and all other wholesale offerings unless specifically listed in Attachments C and E as included in either Basket 1 or 3. A list of wholesale services, with the exception of UNEs, included in Basket 2 at the Price Cap Plan's inception is contained in Attachment D.

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Attachment A:
Terms, Conditions and Operation of the Price Cap Plan

- b) Basket 2 consists of wholesale services many of which are governed by their own specific pricing rules and will continue to be governed by such rules, as interpreted by the Commission and the Courts, under this Price Cap Plan.
 - c) UNEs and discounted Wholesale Offerings are priced based on the provisions of the Telecommunications Act of 1996 (1996 Act), FCC implementing regulations and Commission rules.
 - d) An exception includes Intrastate Switched Access Services which are to be reduced by \$5 million per year for the duration of the initial term of the Plan, with further reductions in Intrastate Switched Access Service rates taking place during any subsequent term of the Price Cap Plan with the objective of obtaining parity with interstate switched access rates.
 - e) Service prices are capped for the term of the Price Cap Plan, or until the specific pricing rules are changed or the Commission determines that other prices are appropriate.
 - f) New wholesale services are to be added to this Basket when those services are implemented.
- 4) Basket 3: Flexibly-Priced Competitive Services
- a) This Basket includes only those services that have been accorded pricing flexibility or have been determined by the Commission to be competitive under A.A.C. R14-2-1108, and new services and new service packages offered by Qwest. Any new services and new service packages offered by Qwest shall be subject to the prior review and approval of the Commission, as provided in subpart e) below. A list of services included in Basket 3 at the inception of this Price Cap Plan is appended hereto as Attachment E.
 - b) The price cap for this Basket is the weighted average price level of all the services in the Basket as calculated by the formula set forth in subpart c) following, subject to annual updates in quantities. Notwithstanding, the additional revenue level for purposes of headroom in Basket 3, shall be capped at \$42.7 million, on a test year basis, for the term of the Price Cap Plan. The price cap will be adjusted upward \$5 million in the second year of the Plan and an additional \$5 million in the third year of the Plan, to reflect the switched access charge reductions in those years.
 - c) The formula for the calculating the Price Cap Index for Basket 3 is:

$$1.0 \geq [\text{SUM } (P_n * Q_b)] / [\text{SUM } (1.134 * P_b * Q_b)]$$

The numerator is the sum of the proposed or new prices multiplied by the "base year" demand. Where price changes have not occurred, the base year price of the service is used. The denominator is the sum of 113.4 percent of the base year prices multiplied by base year demand. P_b and Q_b are the prices and quantities of the services in the basket in the "base" year of the plan. For new services and packages the P_b and Q_b are the prices and quantities for the first full year in which the service is offered. See 4(d) below for further explanation of the

Draft - for March 22, 2001 Open Meeting
Attachment A:
Terms, Conditions and Operation of the Price Cap Plan

appropriate data to be used for new services and packages. The 13.4% increase allowed under the Price Cap Index for Basket 3 is for the term of the Price Cap Plan.

- d) New services and service packages shall be added to the calculation of the price cap index, in both the numerator and denominator, at the end of the year in which they were introduced, to obtain actual experience with the service, so the calculation is not based solely upon projections. Qwest shall provide notification to Staff of the new services/packages and their prices as provided in subpart e) below. Once a full year's worth of actual demand is available for use in the Price Cap Index, that demand should be the "base" year demand to be used,
- e) Any services in Basket 1 may be the components of any new package that would be offered in Basket 3. Each Basket 1 service that is included in a package offered in Basket 3 shall continue to be offered in its current form in Basket 1 as of the commencement of the Price Cap Plan. Any new packages that involve the capped services in Basket 1 shall be filed for review by Staff, pursuant to A.A.C. R14-2-1108. Any new services proposed to be included in Basket 3, shall be submitted at least thirty days in advance of the proposed effective date of the tariff of the new package or service and shall be subject to Commission consideration as provided in A.R.S. § 40-250. The Commission retains the right to reject any proposed classification or filing. The price of the new package or service shall exceed the TSLRIC of the package or service and comply with the imputation requirements of A.A.C. R14-2-1310(c). For purposes of combining Basket 1 services with Basket 3 services and setting a floor for that package, the imputed price of 1FR service shall be the applicable existing retail price for 1FR.
 - i) Qwest shall be required to inform consumers, through its marketing of such new packages, including through its bill inserts, educational materials and customer representative scripts, that the services in Basket 1 remain available and can continue to be purchased as separate offerings.
 - ii) The mere repackaging of existing Basket 1 services does not create a "new service" or "new service package" for purposes of the Price Cap Plan.
- f) Individual service and package prices must provide revenues in excess of the service's or package's TSLRIC subject to the provisions of subpart e) above, unless a different cost standard applicable to all telecommunications service providers is determined appropriate by the Commission. The individual service and package prices must also comply with the imputation requirements of A.A.C. R14-2-1310(c).
- g) [DELETE]
- h) Existing services in Basket 3 shall continue to be offered to existing customer groups. Qwest must receive Commission approval for discontinuation or revision of services, terms and conditions.
- i) A Basket 1 service may be moved to Basket 3 upon Qwest meeting the criteria of A.A.C. R14-2-1108. Staff and Qwest agree that Staff will process such an Application as expeditiously as reasonably possible and, in any event, will complete such processing within a period of six months, unless another time

Draft - for March 22, 2001 Open Meeting
Attachment A:
Terms, Conditions and Operation of the Price Cap Plan

period is agreed to by Qwest, or the six month time period is waived by the Commission.

- j) If a service is moved from Basket 1 to Basket 3 because it has met the criteria of R14-2-1108, the Basket 3 price and quantities for the numerator and the denominator for that service shall be the prices and quantities for that service contained in the numerator of the Basket 1 PCI formula at the time that the service is moved, and the 1.134 factor will not be applied to these services for the remaining term of the plan.
 - k) The Commission's existing rules (A.A.C. R14-2-1109) which prohibit cross-subsidization of competitive services (Basket 3) by non-competitive services (Baskets 1 and 2) shall continue to apply to all services offered by the Company under this Price Cap Plan.
 - l) Price changes to flexibly priced and competitive services contained in Basket 3 shall comply with the requirements of A.A.C. R14-2-1109.
- 5) Annual Filing of Price Cap Data
- a) Price Cap Database: For the first year of the Price Cap Plan, Qwest will file, in electronic form, an Excel spreadsheet that is a database of the prices and quantities of each service in Baskets 1 and 3. The spreadsheet will include the formula for calculating the index of Baskets 1 and 3. The spreadsheet format should enable the Staff to type in a price change and instantaneously observe the effect of the price change on the weighted average price level of the affected Basket. The data in the spreadsheet shall include the following columns for each Basket:

Basket X: (Denominator or Numerator of Price Index)					
Service Name	Tariff Section	Date of Most Recent Price Change	Price	Quantity Demanded	Revenue
A	x.x	01/01/2001	\$x.xx	x,xxx	\$xx,xxx
B	x.x	01/01/2001	\$x.xx	x,xxx	\$x,xxx
TOTAL	----	----	----	----	\$xxx,xxx

This data will be fixed for calculation of the Price Index denominator at each service's price at the beginning of the Price Cap year. A second set of this same data shall be included in the spreadsheet for each Basket and will be updated with each price change throughout the year, cumulatively, in order to calculate the Price Index numerator. The Index for the Basket is calculated as the ratio of the numerator data over the denominator data, as described above for each Basket. The calculated Price Index for each Basket shall remain below the Basket's assigned Price Cap in order for rate changes to be considered lawful upon filing. The spreadsheet shall be equipped with the formula that enables instantaneous verification that a price change by Qwest is within the prescribed cap. For the initial prices, it will suffice to establish the date of most recent price change at 01/01/2001 for all services, particularly if the last price change is unknown. For